"From Virus to Vitamin"
Newsletter

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Stock markets and the real economy: dangerously skewed allocation

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QUESTION UNDER DISCUSSION

"It seems we're confronted with a deepening paradox. While stock markets hit records, the economy is lagging. Is it not the appropriate moment to turn stock markets into engines for growth? But how to achieve this?"

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EDITORIAL

Stock markets and the real economy: dangerously skewed allocation.

The current economic crisis has been called the Great Lockdown despite the fact that stock markets worldwide rebounded in stark contrast with the deterioration in economic indicators. The widening disconnection between the performance of stock markets and the real economy, stronger in the United States but also present in Europe, has baffled even the most sceptical observers.

A possible explanation of this apparent paradox may be in the compositions of key stock market indices which give too much weight to the big tech and pharma/health firms whose business is flourishing because of the crisis. In this case, the average performance of stocks would be much lower than the one captured through indexes and stock markets would "be reflecting the state of things: few are thriving, the rest, that is the vast majority, continue to be depressed."

This being said, good news form stock markets may also be explained by the fact that liquidity generated by central banks and governments in response to the crisis is "captured" by financial markets and diverted from its targeted destination in real economy. The diversion is due to the (apparently) higher attractiveness of stocks in terms of short term risk/reward as compared with other investment vehicles reaching out to the real economy and non-listed businesses: (private) equity financing, bank lending or venture funding, "possibly with some public support for young firms", or even "crowdfunding". The perceived attractiveness of stocks seems to be especially appealing to "millennials" who invest their last pennies because of the illusion that "stocks never fall", and to pension funds who have little alternatives others than zero (or lower) coupon bonds. This situation of diversion and capture should be recognized as a market failure with potentially harmful consequences distorting the allocation of capital at the macro level, nationally and internationally.

On the positive side, the present situation is an opportunity to correct the distortion and bring financial markets closer to the economy by proposing "new rules of the game" to "de-financialize the economy". This could be done by introducing "a transaction tax and a capital gains tax on trading" to reduce high frequency trading or by "banning the massive use of buybacks and stock options that corporations regularly promote in order to artificially boost their performances in the short term", not to mention a ceiling on dividends payouts. Such measures will enhance the medium-term attractiveness of other channels for providing funds to the real economy. The mitigation of long-lasting allocative distortion is clearly within the responsibility of public authorities which should also use policies "of monetary, budgetary and regulatory stability", including "massive sovereign investment". Together, these measures will "drive finance towards sustainable economic projects".

Some of these proposals may seem politically unrealistic or economically untimely since "the (stock) market will become an engine of growth when expectations change for the better, which is not happening at the moment." At the same time, a majority probably agree that these are unprecedented times and that strong action is needed to recast the economic system by putting it on a sustainable long-term path.

Virgile Perret & Paul H. Dembinski

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"… only the big tech and some health are doing well …"

Two reasons seem to explain the divergence between stock markets and the 'real economy': first, there is plenty of liquidity that has to be invested somewhere, and the stock markets seem to be the least uncertain prospect, since COVID has depressed the attractiveness of real estate; second, however, not everything in the stock market seems to be going up: only the big tech and some health are doing really well, and they have a big weight in the main indices. This is probably the reason why the European stock markets are not doing as well as the US. **The stock market seems to be reflecting the state of things: few are thriving, the rest, that is the vast majority, continue to be depressed. The market will become an engine of growth when expectations change for the better, which is not happening at the moment**.

Alfredo Pastor

"… ensuring that firms can access financing to grow requires a broader approach …"

After the fall in the spring due to high uncertainty, the high value of stock markets largely reflects the low level of interest rates, even at very long maturities. Ensuring that firms can access financing to grow requires a broader approach than focusing on stock markets, which after all do not include younger and smaller firms. **Working through bank lending or venture funding, possibly with some public support for young firms, is more promising**.

Cédric Tille

"… the problem is not the stock market but its users …"

The problem is not the stock market but its users. The hope was to encourage investment in the shares of companies which are, ideally, productive in the real economy. Not only was it to make it easier to channel fresh funds to them, but also to recover them easily if the saver needed them. **This motivation has been swamped by buying and selling second-hand securities as mere objects of short-term speculation**. Users anxious to share in the risks, benefits and corporate decision-making as stakeholders in the real economy have become folkloric curiosities who gather in obscure covens like Actares (actares.ch). **To invest in the innovations of the real post-pandemic economy, try crowdfunding**.

Edouard Dommen

"… the result of financialization …"

Unfortunately, the contrary trends in GDP growth and stock market performance is the result of financialization. There is a disconnection between expected profits and share prices; and a strong connection between monetary policies and stock prices. This is aggravated by the fact that some financial institutions are by definition "too big to fail". **They have become risk free, and completely twisted the sense of the stock market as a capital market for new ventures. This dynamic can hardly be turned around unless, I believe, new rules of the game are set and the economy becomes de-financialized**.

Oscar Ugarteche

"… high frequency trading (HFT) contributes roughly 90% of volume in dollar trading markets …"

Stock markets are supposed to lead the real economy through efficient pricing of all available information. This relationship likely no longer holds because **high frequency trading (HFT) contributes roughly 90% of volume in dollar trading markets. A transaction tax and a capital gains tax on trading could reduce HFT. Stock markets may then be more reflective of economic realities**. Consequently, a subdued stock market may cause investments to flow into financing small businesses which frequently have difficulty getting funding. Thriving small and mid-sized businesses employ people. People with jobs spend earnings. Hence, to turn stock markets into engines of growth we need to stop the wealthy from using them as rigged systems to multiply their money.

Kara Tan Bhala

"… banning the massive use of buybacks and stock options …"

The growing gap between "real" economies and the stock markets has become more and more evident since the global financial crisis of 2007-2008 and the current covid-19 related crisis: up to date, stock markets have been recovering well, and in some cases (Nasdaq, S&P 500) even performing better than before the pandemic, while real economies are struggling everywhere globally, in an historical moment of crisis. T**he apparent "schizophrenic" behaviour of the stock markets in relation to real economies, could be, at least in part, prevented by banning the massive use of buybacks and stock options that corporations regularly promote in order to artificially boost their performances in the short term, thus neglecting to focus and invest into sustainability and innovation**.

Valerio Alfonso Bruno

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"… the aim of finance is finally to serve the society …"

As proposed by Karl Polanyi, finance is a skill serving the economy and thus the social project. The aim of finance is finally to serve the society and act for the living. High level of public regulations, monetary policies via massive sovereign investment could be key factors to monitor and drive finance through sustainable economic projects. The only private investment will not be sufficient to reach the objective, as mainly based on markets. The question of growth definition is also important: can we really talk about green capitalism or green growth? **The combination of using resources (natural, human, living) to grow and reduce the use of resources to reach the SDGs is no more stable and must be rethought about direct investment in companies serving circular and resilient projects**.

Christophe Revelli

"… not a matter of the financial sphere alone …"

The disconnection between the stock markets (and should be added real estate markets) and the real economy is not a matter of the financial sphere alone. The fragility of the global interconnected economic system, which results in a high sensitivity to risks, increases the importance of the financial sphere, while paralyzing consumers and investors. **Financial markets are less sensitive to the anticipated economy - which should be their role - than to the lax monetary policy of central banks. The solution is therefore in the hands of the public authorities through a policy of monetary, budgetary and regulatory stability**.

Etienne Perrot

"… equity financing for companies should regain prevalence …"

- Stock market optimism relies on a basic confidence in society that economy will recover from the pandemic.
- **In general, equity financing for companies should regain prevalence, so as to reduce risks attached to "financialization" and debt overhang**; the stock market can direct investment towards more dynamic and productivity enhancing areas of business, whereas debt-based assets look basically for security. Tax reform is required so that interest paid by companies ceases to be easily deductible as cost.
- Retired people are essential though "passive" actors of any reform, but the transgenerational factor is mostly absent from economic thinking. A more active role for equity financing and stock markets requires, among other, changing the priorities set for pension fund managers.

Domingo Sugranyes

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"… reverse the damage to capital formation caused by low transaction-cost digital markets …"

At a time when the global economy is revolving under the pandemic and economic activity has been among the worst affected due to the extreme nature of the lockdown, when domestic investors are withdrawing their money, why did foreign investors pour so much money into stock markets? This merits closer analysis. The answer is not flawless, but the circumstances certainly call for a closer investigation by stock exchanges and the implementer. **Implementers and stock exchanges throughout the world are expected to increase their efforts to find ways to reverse the damage to capital formation caused by low transaction-cost digital markets. This reversal will accelerate healthy economy and job growth**.

Archana Sinha

"… the increasing focus of major stock markets on trading and speculation …"

The lack of connection of real activity and stock markets observed during the first 7 months of 2020 reflects the availability of liquidity generated by easy monetary policies and the increasing focus of major stock markets on trading and speculation (with volumes and high frequency transactions serving little or no social purpose). **The markets dominating the daily news are primarily secondary markets for financial instruments, not vehicles for financing real activity. Major sources for the latter are debt in the form of bank loans (including those of state institutions), bonds, own funds, and institutions and markets which specialise in financing small firms and start-up equity investments. Improving the functioning of the latter sources seems a more plausible way forward than trying to turn major stock markets into major vehicles for financing real activity**.

Andrew Cornford

"… stocks globally are often largely owned by institutional investors …"

Are today's high stock market valuation sustainable, what fundamentals really drive these high valuations? Stocks globally are often largely owned by institutional investors. Given their size, these investors reach full risk diversification quickly and often times own a very wide range of investments: they are universal owners. Their investment orientation allows, often prescribes, a longer-term investment horizon given future liabilities. **As such, institutional investors are very well positioned to divest part of their highly-valued stocks now and invest in sectors which, inevitably, will have to show the highest growth in the mid to long term: namely sectors which develop answers to climate change risk, to pressing social needs and similar. In this way, good investment sense meets fiduciary duty, to members, beneficiaries, and society at large**.

Eelco Fiole

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Dr. **Eelco Fiole**, CFA, LLM is an investment governance expert, board director and adjunct professor of Finance Ethics in Lausanne and Neuchatel. He was a CFOO for almost 10 years in (alternative) investment management and blockchain, and holds advanced degrees in various academic domains. Thriving on idiosyncrasies and deeply international in his outlook, he is increasingly currently focused on social innovation.

Alfredo Pastor

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Observatoire de la Finance

“FROM VIRUS TO VITAMIN” – JOIN THE DISCUSSION

The Observatoire de la Finance intends to seize this period of pandemic to step back and take a fresh look at our global economic system, dare to ask new questions which the current crisis brings to the fore and propose innovative ways to rebuild a more resilient and sustainable economy and society. In brief, we want to turn the virus into a vitamin for the future.

Our Discussion Board “From Virus to Vitamin” focuses on commenting issues relevant to finance and economy in relations to society, ethics and the environment from a variety of perspectives, of practical experiences and of academic disciplines. It has been designed to share and discuss information and opinions expressed in a short and concise manner.

Contributors (Discover the list of contributors) are invited to react on a question/issue that is submitted in parallel to a limited group of experts. This happens on a regular basis, through a dedicated mailing list. After the deadline for submission, the reactions are edited and published with signatures in one document on the website of the Observatoire de la finance and on its Linkedin page. If you would like to join the discussion, you may send an email to the editor, Dr. Virgile Perret <perret@obsfin.ch>.

OF Discussion Board – Questions addressed so far

- Question 8 : Stock markets and the real economy: dangerously skewed allocation
- Question 7 : Realigning international trade according to the full cost principle
- Question 6 : Indulgent creditors and industrial policy
- Question 5 : Caring for care
- Question 4 : The changing nature of GAFAs: global market players, national champions or public service providers?
- Question 3 : Squaring the circle between international good intentions and national (weak) institutions
- Question 2 : A simplistic and misleading trade-off but policy dilemmas are real
- Question 1 : Convictions rarely change… but they get refined

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